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Framework for the Presentation & Preparation of Financial Statements

Question 1

What are the qualitative characteristics of the financial statements which improve the usefulness of the information furnished therein? (4 Marks, May, 2007 and November, 2008)(PCC)

Answer

The qualitative characteristics are attributes that improve the usefulness of information provided in financial statements. The framework suggests that the financial statements should observe and maintain the following qualitative characteristics as far as possible within limits of reasonable cost/ benefit.

1. *Understandability*: The financial statements should present information in a manner as to be readily understandable by the users with reasonable knowledge of business and economic activities. It is not right to think that more disclosures are always better. A mass of irrelevant information creates confusion and can be even more harmful than non-disclosure. No relevant information can be however withheld on the grounds of complexity.
2. *Relevance*: The financial statements should contain relevant information only. Information, which is likely to influence the economic decisions by the users, is said to be relevant. Such information may help the users to evaluate past, present or future events or may help in confirming or correcting past evaluations. The relevance of a piece of information should be judged by its materiality. A piece of information is said to be material if its omission or misstatement can influence economic decisions of a user.
3. *Reliability*: To be useful, the information must be reliable; that is to say, they must be free from material error and bias. The information provided are not likely to be reliable unless:
   (a) Transactions and events reported are faithfully represented.
   (b) Transactions and events are reported in terms of their substance and economic reality not merely on the basis of their legal form. This principle is called the principle of 'substance over form'.
   (c) The reporting of transactions and events are neutral, i.e. free from bias.
   (d) Prudence is exercised in reporting uncertain outcome of transactions or events.

4. *Comparability*: Comparison of financial statements is one of the most frequently used and most effective tools of financial analysis. The financial statements should permit both inter-firm and intra-firm comparison. One essential requirement of comparability is disclosure of financial effect of change in accounting policies.
5. *True and Fair View*: Financial statements are required to show a true and fair view of the performance, financial position and cash flows of an enterprise. The framework does not deal directly with this concept of true and fair view, yet the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements portraying true and fair view of information about an enterprise.

Question 2

"One of the characteristics of financial statements is neutrality"- Do you agree with this statement? (2 Marks, May, 2008) (PCC)

Answer

Yes, one of the characteristics of financial statements is neutrality. To be reliable, the information contained in financial statement must be neutral, that is free from bias. Financial Statements are not neutral if by the selection or presentation of information, they influence the making of a decision or judgment in order to achieve a pre-determined result or outcome. Financial statements are said to depict the true and fair view of the business of the organization by virtue of neutrality.

Question 3

What are the qualitative characteristics that improve the usefulness of information provided in the financial statements? (4 Marks, November, 2011and May, 2013) (IPCC)

Answer

The following qualitative characteristics will help in improving the usefulness of the information provided in the financial statements:

1. Understandability: Information in financial statements should be presented in a manner that the users with reasonable knowledge of business and economic activities and accounting, may readily understand it. All relevant information should be given therein.
2. Relevance: The relevance of a piece of information should be judged by its materiality i.e. whether its omission or misstatement can influence economic decisions of users or not. No relevant information should be withheld on the grounds of complexity.
3. Reliability: The information are said to be reliable when transactions and events reported are represented faithfully and also when they are reported in terms of their substance and economic reality. Prudence concept is also used whenever required.
4. Comparability: The financial statements should permit both inter-firm and intra firm comparison. One essential feature or requirement of comparability is disclosure of financial effect of change in accounting policies.
5. True and Fair view: Financial statements are required to show a true and fair view of the performance, financial position and cash flows of an enterprise.